United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

ORIGINAL

76-7406

To be argued by
JONATHAN S. GAYNIN

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P/S

United States Court of Appeals

FOR THE SECOND CIRCUIT

MAXIME C. BARETGE; ROCKLEY ASSOCIATES, S.A.; PIERRE MACHERAS; DAVID W. TRIMBLE; THE ROCKLEY GROUP, INC.; BAZOCHE, INC.; WALBORG CORPORATION; and COBLENTZ BAG CO., INC.,

Plaintiffs-Appellants,

—against—

NORMAN N. BARNETT, JULIENNE BARNETT, and VI L. MESSERLI,

Defendants-Appellees.

Appeal from a Judgment and Order of the United States District Court for the Southern District of New York

APPELLEES' BRIEF

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CITATIONS

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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Maxime C. Baretge; Rockley Associates, S.A.; Pierre Mocheras; David W. Trimble; the Rockley Group, Inc.; La Bazoche, Inc.; Walborg Corporation; and Coblentz Bag Co., Inc.,

Plaintiffs-Appellants,

-against-

Norman N. Barnett, Julienne Barnett, and Vi L. Messerli,

Defendants-Appellees.

APPELLEES' BRIEF

Preliminary

Appellants' brief, like its complaint, is an attempt to incite this Court, as it tried to do with the Court below, so that it will overlook the deficiencies in the complaint. The Court below was not fooled by this technique, and after "a careful reading of the [the] complaint", dismissed it for failure to state a claim under Section 10b of the Securities Exchange Act of 1934. The District Court was justified and correct in its dismissal,

because in spite of the liberal use of certain "key" words, no securities claim against Appellees is stated.

No claim is stated because the Appellees were not sellers of securities in violation of Rule 10b-5, nor were Appellants buyers thereof from Appellees, any alleged wrongdoing did not take place in connection with any purchase or sale of securities, the alleged misstatements by Appellees do not constitute misrepresentations under Rule 10b-5, nor were there material omissions, reliance by the Appellants is absent, or if alleged, is inappropriate, and in general, the complaint alleges no federal claim by the individual Appellants against the Appellees, but constitutes, if anything, allegations which properly belong to the corporate Appellants against the Appellees for at most, a state claim of mismanagement and waste. This is not to concede that an allegation of corporate waste and mismanagement is appropriately alleged, but rather that the real crux of all of the allegations made in the complaint is one belonging in the state Court, and that the remaining allegations are merely a vain attempt to try to establish some sort of claim under the security laws, in order to litigate this matter in a Federal Court.

The awareness by the Appellants of the weakness of their claim under Rule 10b-5 is made clear by Appellants'

resort to a hedge against the possibility of the Court finding that no security claims are asserted by the complaint. Appellants also suggest in the complaint that the jurisdiction rests upon diversity of citizenship with respect to Counts I and II. The same Counts purportedly alleging security violations. In fact, no diversity exist either. The District Court having found that Appellees were not sellers within the Act and the Appellants were not purchasers within the Act, needed to go no further with respect to all the other deficiencies of the complaint and chose not to do so.*

The Issues Presented For Review

1. To state a claim under Section 10b, must the Appellees be "sellers" either actual or of securities in violation of Rule 10b-5?

2. To state a claim under Section 10b of the Securities Exchange Act of 1934, must the Appellants actually be purchasers of the securities related to an alleged fraudulent scheme?

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*This Court is not bound to sustain dismissal, only upon the grounds asserted by the District Court, but may rely on other grounds or additional grounds. Riley Co. v. Commissioner, 311 U.S. 55 (1940); Lum Wan v. Esperdy, 321 F.2d 123 (2d Cir. 1963). A dismissal herein can even be affirmed even if a legal theory is being asserted for the first time in this Court. Southard v. Southard, 305 F.2d 730 (2d Cir. 1962).

3. Is the mere claim of corporate waste or mismanagement unconnected with any alleged purchase of securities sufficient to state a claim under Rule 10b-5 of Section 10b of the Securities Exchange Act of 1934?

4. Does the complaint state a claim under Rule 10b-5 and Section 10b of the Securities Exchange Act of 1934?

The Facts in Brief

This action is the result of acrimony arising between the individual Appellants and Appellee Barnett. The acrimony developed over disputes arising from the internal affairs and operation of Appellant corporations. A settlement was negotiated by counsel between Appellants and Appellees, pursuant to which Appellee Norman N. Barnett gave up his positions with the corporations, a substantial equity interest held by him, a voting trust and his employment contract in exchange for a monetary payment, general releases from all Appellants running to him, and an expected peace of mind. Within thirty (30) days after giving up his employment agreement, his positions and substantial equity interest, for the general releases running from Appellants to Appellees Norman N. and Julienne Barnett, the Appellants commenced this action (A-28-29, paras 41-42-43).*

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*References in parentheses refer to pages of the appendix and to paragraphs of the complaint unless otherwise noted.

Statement of the Case

The gravalmen of the complaint are allegations of corporate waste and mismanagement on the part of Appellee Norman N. Barnett ("Barnett"). From practically the very opening paragraph of the complaint (A-9, para 10) to practically the last paragraph of the complaint (A-30, para 46), the allegations relate to purported wrongdoing by Appellees in connection with their positions at the corporation and not any role connected with the sale of securities. Indeed, Counts I, II and IV specifically hinge upon the allegations of Count III which is conceded to be a state claim, if any, of purported corporate waste and mismanagement (see p. 11 of Appellants brief). If the other Counts were striped bear of references to Count III, they would fold like a deck of cards. None of the allegations concering corporate waste and mismanagement are connected in time and relationship to any purchase of securities by the Appellants or sale by the Appellees.

The basic claim in Count I of Appellants' complaint is that Appellee Barnett failed to disclose to the individual Appellants when they acquired an interest, at some unspecified time, in the Rockley Group, Inc. ("Rockley") that Appellee Barnett intended to dissipate the assets of a third corporation, Walborg Corporation ("Walborg") whose

stock had been acquired by La Bazoche, Inc. ("La Bazoche"). At some later point in time, after the purchase of the Rockley stock by Appellants, it is claimed Barnett wasted and mismanaged the assets of Walborg (A-9, para. 10; A-17 para. 22). It is conceded by Appellants' complaint that the sophisticated and individual Appellants did not purchase any stock of Walborg or La Bazoche, the company which acquired Walborg, but rather Rockley which was organized later (A-12, para. 16). There is no claim that any of the Appellees sold any Rockley stock to any of the individual Appellants. There is also no claim that any of the Appellants purchased a single share of Rockley until after La Bazoche had acquired Walborg. Finally, the complaint fails to disclose when the actual purchase of shares by the individual Appellants in any company occurred.

The complaint obliquely refers to a "unanimous consent" dated June 11, 1974, apparently negotiated and entered into by the Appellants and Appellee Barnett (A-15-16, para. 20). A further reference is made in the complaint that as of March 29, 1976, the individual Appellants owned certain amounts of stock of Rockley either directly or, in the case of Appellant Baretge, beneficially through a Panamanian corporation, and in the case of Trimble, beneficially through some unknown entity (A-6-7, para. 2). It is not explained by the complaint when the individual

Appellants acquired their shares of Rockley, but by adding the figures of Rockley stock mentioned in Count I and II, all of the alleged purchases are traceable to those Counts and none to Count IV (A-15-16, para. 20; A-21, para. 30).

The complaint acknowledges that the individual Appellants are wealthy, sophisticated and experienced businessmen; they are familiar with the use of nominee corporations, high finance and even (at least as to Appellant Baretge), the meaning of public offerings under the securities laws. The complaint further acknowledges that full disclosure about the nature and structure of Rockley, La Bazoche and Walborg was given to the individual Appellants by Barnett. According to the complaint the individual Appellants were told about the:

1. Appellee Barnett's voting trust and sole voting power over La Bazoche (A-14, para. 17(b)).

2. Walborg's acquisition by La Bazoche was accomplished through borrowed funds (A-11-12 para. 15, A-14-15, para. 18).

3. Appellee Barnett had not contributed most of the funds for the acquisition of Walborg but had guaranteed certain bank loans, the proceeds of which were used to finance Walborg's acquisition (A-11-12, para. 15, A-14-15, para. 18).

4. Rockley did not own the acquired corporation, Walborg, rather a subsidiary of Rockley, La Bazoche owned Walborg and La Bazoche was subject to a voting trust which gave Appellee Barnett control over it (A-11-12, para. 15; A-14, para. 17(b)).

Because of the amount of disclosure conceded by the complaint, Appellants have been reduced to asserting far fetched and insignificant statements as a basis for claim of misrepresentation. None of this purported misrepresentations are connected with the alleged wrongdoing and injury to Walborg, and for this reason alone, cannot be a basis for a claim under Rule 10b-5. However, since Appellants' brief places so much emphasis on these purported misrepresentations, they will be discussed by Appellees.

Typical of the far fetched "misrepresentations" relied upon by Appellants, is a statement attributed to Appellee Barnett in Count I purportedly made to a third-party, Richard Weinberg, concerning the reason for the creation of La Bazoche (A-14-15, para. 17(a)). To begin with Weinberg is not a party to this action and certainly was not a purchaser or seller of any shares in connection with the basis of this action. There is no claim that any purported misrepresentation made to him in the presence of any of the Appellants nor imparted to them. Furthermore,

the substance of the purported representations is insignificant since the reason for the creation of La Bazoche is not material, but only the fact of its creation and its function are material. It is conceded by the complaint that the creation and function of La Bazoche was disclosed to Appellants (A-11-12, para. 15; A-14, para. 17(b)).

It is also alleged in Count I that Appellee Barnett, in disclosing to the individual Appellants that he had sole voting power over La Bazoche, the company that acquired Walborg, he "falsely" represented the reason for his having the voting power (A-14, para. 17(b)). Significantly, it is not claimed that the voting trust held by Barnett was not disclosed to the individual Appellants, but rather, that the jurisdiction for the voting trust was inaccurate. Clearly, this statement cannot constitute a claim under Rule 10b-5 of the Act. The significant information that a voting trust for La Bazoche existed and that through it Appellee Barnett had sole voting power is conceded by the complaint to have been disclosed by Appellee Barnett to the individual Appellants (A-14, para. 17(b)). Appellants seizure upon a rather insignificant and meaningless statement as the basis for violation of Rule 10b-5, is only a further indication of the baselessness of their

claim. This alleged statement is not even alleged to be part of the fraudulent scheme and cannot be a basis for a claim of action under Rule 10b-5.

Another alleged false representation in Count I is asserted to be embodied in the "unanimous consent" negotiated among the individual Appellants and Appellee Barnett (A-15-16, para. 20). This document sets forth arbitrary considerations arrived at by the Appellants and Appellees for purposes of establishing a basis (more likely for tax reasons) for the issuance of the shares of Rockley. No weight can be given to this document as far as any claim under Rule 10b-5, for two reasons. First, the "unanimous consent" could not be part of any scheme to utilize Walborg's assets. Secondly, the "unanimous consent" is patently a negotiated and arbitrary document. Practically none of the consideration set forth therein involved actual cash payment due or to be paid at the time of issuance of the stock. Indeed, much of the consideration consisted of values placed on services purportedly rendered by the individual Appellants, as well as Appellee Barnett. Appellant Baretge had loaned money prior to the preparation of the document, so no reliance could have been placed on it by him on this document. (A-11-12, para. 15).

Finally, there is the overriding claim of corporate waste and mismanagement, not with respect to Rockley but with respect to Walborg. There is no claim that any moneys, if advanced by the individual Appellants pursuant to the "unanimous consent", were appropriate by Appellee Barnett. Indeed, only Baretge is alleged to have advanced any money in Count I, and that money, it is claimed, went to the Weinbergs and not to Barnett (A-11-12, para. 15).

Count II of the complaint is patently absurd. The complaint alleges that the individual Appellants were repeatedly told by Appellee Barnett that he did not have current financials because of problems with the IBM computer system being used for the Appellant corporations (A-20, para. 27). Forewarned with this knowledge, the claim of the individual Appellants that they relied upon Barnett's report made at the Board of Directors (which they attended because they were directors), in his official capacity, with respect to his estimate as to how sales of the subsidiaries were progressing, is totally unreasonable (A-20, para. 28).

It is not claimed by the individual Appellants that Appellee Barnett had current financials, but rather, it is claimed that prior to the computer problems, Rockley

had been issuing quarterly financial statements (A-20-21, para. 29). Clearly, armed with the disclosure that current financials were not available and, therefore, Appellee Barnett's report to the Directors could only be an estimate, no claim can be made under Rule 10b-5 that the individual Appellants placed, or should have placed, any reliance upon these estimates with regard to any purported purchase of Rockley stock.

Interestingly, the complaint asserts that the estimate of sales of approximately $5,500,000 made by Appellee Barnett at the Board of Directors meeting was extremely close to the essential total, and was off by only 11% (A-20-21, para. 29). Such a small variance cannot possibly constitute a material misrepresentation.*

Count III is conceded to be a pendant claim and was properly dismissed when the Court found the complaint asserted no basis for Federal jurisdiction. It is pointless to go into the various allegations since it has no bearing on whether a Federal claim exists.

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*It is asserted in Appellants' brief (at p. 8 subparagraph (c)), that Barnett failed to inform the individual Appellants that Rockley and its subsidiaries were on the verge of insolvency and could not pay their debts prior to the alleged second purchase of shares by Appellants. The court is then referred to paragraph 31 of the complaint (A-21, para. 31). No such allegation concerning insolvency is contained in paragraph 31. Consequently, this claim must be ignored.

One thing about Count III is of significance, however, the claim is asserted by the corporate Appellants and not the individual Appellants. This is clearly a recognition by the Appellants that any claim for waste and mismanagement properly belongs to the corporations and not the individuals; therefore, no diversity of jurisdiction can exist since it is conceded that the corporate Appellants reside in the same jurisdiction as the Appellee.*

Count IV of the complaint is patently fatuous. The Appellants who brazenly forced the Appellee Barnett out of the business and to relinquish his interest in it, now claim he violated the Securities Law when he was forced out. Such a claim borders on the Twilight Zone.

It is acknowledged by the complaint that Barnett was forced by the individual Appellants to give up his positions with the corporations, to relinquish all of his equity interest in the corporation and give up his employment agreement (A-28-29, para. 42). In return, Barnett was to recieve (a promise which was never kept), the sum of $60,000, the opportunity to purchase the car which he had

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*An action for waste, mismanagement and misappropriation constitutes a wrong committed upon the corporation and not its stockholders, Dalva v. Bailey, 153 F. Sup. 548 (S.D. N.Y., 1957).

been using while with the company, and general releases from all of the Appellants (A-28-29, par. 42). Appellee Barnett has not received any of the sum due him and the general releases given to him by Appellants have not been adhered to. Moreover, the Appellants knew they did not have the corporate records when they executed the releases, but their releases contain no exception with regard to this. (A-29, Par. 43).

If anyone had a gun to his head, it was Appellee Barnett. He was the only one who had guaranteed the loans which were well over $1 million (A-11-12, Par. 15; A-20, Par. 28; A-28, Par. 41). He was the only one who faced financial ruin. Thus, the "settlement" was imposed upon him by the individual Appellants who got exactly what they wanted (A-28-29, Par. 42).*

In Count IV, no claim of any misrepresentation nor of omission is alleged. Reference is made to the fact that Appellee Barnett was holding the corporations' records for safekeeping in his possession pending the consummation of the settlement arrangements (A-29, Par. 43). Nothing contained in the corporations' records would have changed Appellants' desire to force Appellee Barnett out through a

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*Incredulously, Appellants' counsel boasted to the District Court, in their memorandum opposing the motion to dismiss, that the Appellant corporations, owned in total by the individual Appellants, were making a profit.

settlement. Appellants concede in the complaint, that they were fully aware of the financial condition of the corporations when they "settled" and signed the general releases running to the Appellee Barnett and his wife (A-28-29, paras. 40 and 42). If Appellants were willing to settle in the state of the financial condition alleged in the complaint, then clearly, any information contained in the corporate records could not have been material to the Appellants.

Moreover, there is grave doubt that any "purchase" of shares by the Appellants took place as part of the settlement, none if alleged in Count IV. It is claimed at the beginning of the complaint that Appellee Baretge or his Panamanian nominee owned a total of 2,540 shares (A-6-7, para. 2). In Count I it is alleged that Appellee Baretge acquired 800 shares of Rockley stock and, in Count II, it is alleged that he acquired 1,840 shares of Rockley stock, for a total of 2,540 shares (A-21, para. 30). Thus, all of the Rockley stock purportedly owned by Appellant Baretge is accounted for under Counts I and II.

With respect to Appellant Trimble, it is alleged in Count I, that he had the right to purchase 550 shares and appears to have the right to purchase the balance of his shares in Count II (A-15-16, para. 20; A-21, para. 30). Accordingly, none of his shares were acquired under Count

IV. Appellant Macheras is alleged in Count I to have the right to purchase all of his shares that is claimed he eventually owned (A-6-7, para 2(b)); A-15-16; para. 20(c)). Thus, none of the share purportedly owned by the individual Appellants could have been purchased pursuant to Count IV. Indeed, there is no allegation in Count IV that any shares were purchased from Appellee Barnett by any of the Appellants (A-28-29, para. 42).

None of the purported misrepresentations discussed above were involved in any fraudulent scheme or injury which is alleded in the complaint. The injury alleged in the complaint relates to purported acts committed by Appellees with respect to the management of Walborg. The fraudulent scheme alleged in the complaint relates to Appellees actions with regards to Walborg. None of the claimed misrepresentations contained in the complaint relate to either the injury or the fraudulent scheme. Accordingly, no scheme under Rule 10b-5 is stated for this reason as well.

POINT I

The Complaint fails to state a Claim under Rule 10b-5 and Section 10b.

A. The Appellees were not "sellers", nor were the Appellants buyers.

The District Court dismissed the Appellants' complaint herein because it failed to state a claim under Rule 10b-5 and Section 10b of the Securities Exchange Act of 1934. It must be assumed, although not stated, since the complaint was dismissed in its entirety, that the District Court determined that there was no other basis for Federal jurisdiction, such as diversity of citizenship.

Appellants' brief fails to set forth the relevant statutory and regulatory provisions upon which their complaint purports to rely and from which it was dismissed. Since those statutory and regulatory provisions are indispensable to any decision in this matter, they are set forth herewith.

Section 10b of the Securities Exchange Act of 1934 (hereinafter referred to as the "Act") proves as follows:

> "Sec. 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange --

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange of any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." [Emphasis supplied.]

Rule 10b-5, 17 CFR, Section 240.10b-5, promulgated by the Securities and Exchange Commission, provides as follows:

"'Sec. 240.10b-5 Employment of manipulative and deceptive devices.

'It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

'(a) To employ any device, scheme, or artifice to defraud,

'(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

'(c) To engage in any act, practice or course of business which operates or would operate as a

fraud or deceit upon any person,

'in connection with the purchase or sale of any security.'" [Emphasis supplied.]

The District Court, in dismissing Appellants' complaint, stated the following:

> "A careful reading of this complaint shows with respect to Counts I and II that neither the moving defendants nor Messerli were 'sellers' of securities in violation of Rule 10b-5; nor were plaintiffs buyers thereof from defendants. However, the pleading be characterized or described, it fails to state a claim under Sec. 10b of the 1934 Act in either of these counts. Blue Chip Stamps v. Manor Drugstores, 421 U.S. 723 (1975). Even before Blue Chip we had been cautioned more than once against 'a trend we have observed with disturbing frequency, namely, invocation of the salutary anti-fraud provisions of the federal securities laws in cases where those provisions are wholly inappropriate and wide of the Congressional mark.' [Quoted from Kavit v. A. L. Stamm & Co., 491 F.2d 1176 (2d Cir. 1974), relying in turn on Ryan v. J. Walter Thompson Co., 453 F.2d 444, 445 (2d Cir. 1971)].
>
> Under the circumstances, there is no basis to exercise pendent jurisdiction.
>
> Motion granted. Complaint dismissed as to all defendants, including Messerli.
>
> So Ordered."

The first thing which is readily apparent from the District Court's opinion is the fact that the Court carefully read Appellants' complaint. This aspect of the decision is important because many allegations of Appellants' complaint are couched in terms commonly associated with Rule 10b-5 cases, but an analysis of the allegations leads to one

simple conclusion, the complaint fails to allege any claim under Rule 10b-5. The claim asserted in the complaint, if any, is for corporate waste and mismanagement. The allegations of the complaint even contain allusions to claimed false statements and misrepresentations. But not every false statement or misrepresentation, even if made, is automatically a basis for a Rule 10b-5 claim, certain prerequisites must be present. It was clear to the District Court that the complaint was insufficient to support a claim under Rule 10b-5. The District Court could have determined that the complaint was insufficient on many bases. Several bases were offered to the District Court by the Appellees.* However, the District Court determined that an elemental and critical ingredient for stating a claim under the Act was lacking. Having reached this conclusion, the District Court chose to go no further, and it did not have to.

Appellants' brief (at p. 17) attacks the District Court and its capacity to understand the recent decision of the United States Supreme Court in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). Appellants' attack

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*The Appellants have portrayed to this Court that the grounds for dismissal raised by Appellants were limited. This is not so.

on the District Court is unwarranted and the very accusation it levels against the District Court is one of which they are guilty.

The Supreme Court in Blue Chip Stamps v. Manor Drug Stores, supra, 421 U.S. 723, refused to extend the applicability of Section 10b and Rule 10b-5 beyond the expressed language of the Section and Rule. The Supreme Court in Blue Chip Stamps held that a private damage action under Section 10b and Rule 10b-5 is limited to actual purchasers and sellers of securities. The Court further recognized that the purchase and sale must be connected to any alleged fraudulent wrongdoing.

The Supreme Court in Blue Chip Stamps, was following the rule laid down by this Court in Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952), cert. den., 343 U.S. 956 (1952) and other circuit courts in Landy v. FDIC, 486 F.2d 139 (3rd Cir. 1973), cert. den., 416 U.S. 960 (1974); Sergeant v. Genesco, Inc., 492 F.2d 750 (5th Cir. 1974); Simmons v. Wolfson, 428 F.2d 455 (6th Cir. 1970), cert. den., 400 U.S. 999 (1971); City National Bank v. Vanderboom, 422 F.2d 221 (8th Cir. 1970), cert. den., 399 U.S. 905 (1970); Mount Clemens Industries, Inc. v. Bell, 464 F.2d 339 (10th Cir. 1972). The Supreme Court in reversing the Court of Appeals below, succinctly stated the

following in support of the adoption of this Court's rule laid down in Birnbaum (at p. 733 of 421 U.S.):

> "The longstanding acceptance by the courts, coupled with Congress' failure to reject Birnbaum's reasonable interpretation of the wording of Section 10(b), wording which is directed toward injury suffered 'in connection with the purchase or sale' of securities, argues significantly in favor of acceptance of the Birnbaum rule by this Court."

The District Court, in reading its decision in this action dismissing the complaint, followed the mandate laid down by the Supreme Court in Blue Chip Stamps. Appellants' complaint alleges no injury or fraudulent wrongdoing by the Appellees in connection with a purchase or sale of stock. The wrongdoing alleged by the complaint, if any, relates to the subsequent operation of the Walborg corporation by Appellees.

The nexus of the complaint is simply that the Appellees were guilty of malfeasance by committing corporate waste and mismanagement in the operation of Walborg (A-9, 10, para. 10 and A-17, para. 22). None of the alleged corporate waste and mismanagement occurred in connection with any purchase of Rockley stock by the individual Appellants. Moreover, the individual Appellants have never sold their Rockley stock and have incurred no loss.

This Court has been faced before with claims similar to those asserted by the Appellants. In Greenstein

v. Paul, 400 F.2d 580 (2d Cir. 1968) allegations similar to those asserted here, was alleged by the plaintiff. In affirming the dismissal of the complaint this Court said (at p. 581 of 400 F.2d).

> "The individual defendants are alleged to be also the directors and officers of Sagamore. They are charged in the complaint with conspiring with one another to syphon the assets and income of Sagamore into Syndicate for its use, depressing the market value of Sagamore's stock below its fair value on the over-the-counter market where the stock was traded, so as to purchase shares of the minority stockholders at depressed prices and effectuate their "freeze-out."
>
> The court below granted the defendants' motion for summary judgment on the ground that the complaint failed to allege, and indeed an undisputed affidavit established that the plaintiff had not sold any of his Sagamore stock during the time when the defendants committed the alleged wrongs but in fact acquired his stock prior to the acts of the defendants of which he complains and had never parted with any of it. The question then is whether there must be a sale of stock by a plaintiff before he can invoke the implied civil remedy afforded by the Act and Rule cited hereinabove. See Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 543 (C.A. 2, 1967), citing J. I. Case Co. v. Borak, 377 U.S. 426, 84 S.Ct. 1555, 12 L.Ed.2d 423 (1964).
>
> It has long been the rule in this circuit that to maintain an action under Section 10(b) of the Act and Rule 10b-5 of the Securities and Exchange Commission the plaintiff must have been a seller of the stock involved. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (C.A. 2, 1952), cert. denied 343 U.S. 956, 72 S.Ct. 1051, 96 L. Ed. 1356 (1952)."

Other complaints with allegations similar to Appellants' were also dismissed because the alleged purchase or sale was not connected with the alleged fraudulent wrongdoing and injury. Simmons v. Wolfson, 428 F.2d 455 (6th Cir. 1970), cert. den., 400 U.S. 999 (1971); Rochelle v. Marine Midland Grace Trust Co. of N.Y., 535 F.2d 523 (9th Cir. 1976); Hoover v. Allen, 241 F. Supp. 213 (S.D.N.Y. 1965); Lester v. Preco Industries, Inc., 282 F. Supp. 459 (S.D.N.Y. 1965); Phillips v. Tobin, 403 F. Supp. 89 (S.D.N.Y. 1975); Walner v. Friedman, 1975-76 Transfer Binder, CCH Fed. Sec. L.Rep. Para. 95,318 (S.D.N.Y. 1975).

The injuries asserted by the complaint do not relate to any claimed purchase of Rockley stock. The injuries alleged in the complaint took place long after any alleged purchase. To make up for the fact that the alleged fraudulent wrongdoing and injury did not occur in connection with the purchase of any securities, Appellants have sprinkled their complaint with purported instances of false statements and misrepresentations. All of the alleged misrepresentations and false statements are insignificant and unrelated to the purchase. It has already shown that in this brief any material fact was disclosed to the Appellants.

The Appellants have referred to three (3) cases in support of their contention that the complaint states a

cause of action under Rule 10b-5. The cases are Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 7 (1971); A. T. Brod & Co., v. Perlow, 375 F.2d 393 (2d Cir. 1967) and Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974). None of these cases involve the issue which the District Court found controlling in this action. None of the cases hold that a claim under Rule 10b-5 exist where the alleged wrongdoing and injury are not connected with the purchase or sale of securities. In Bankers Life, Brod and Schlick the alleged wrongdoing was specifically found to be connected with a purchase or sale of securities.

Moreover, in Superintendent of Insurance v. Bankers Life & Casualty Co., supra, 404 U.S. 6 (1971), the Supreme Court specifically recognize that the internal affairs and operations of a corporation were not covered by Section 10b unless connected with a sale or purchase of securities. The Supreme Court state as follows (at p. 6 of 404 U.S.):

> "Congress by Section 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement. But we read Section 10(b) to mean that Congress meant to bar deceptive devices and contrivances . . . .

The applicability of the Bankers Life case to a claim being asserted by Appellants was addressed by the

Court of Appeals for the 6th Circuit on Landy v. FDIC, supra, 486, F.2d 139 (3rd Cir. 1973), cert. den. 416 U.S. 690 (1974). The Court of Appeals in Landy held that Bankers Life was inapplicable to facts similar to those asserted by Appellants. In Landy, plaintiff's shareholders brought the action under Rule 10b-5 against defendants because of losses sustained by a bank as a result of misuse of bank funds related to securities speculation. The District Court dismissed the complaint. The Court of Appeals for the 6th Circuit affirmed. The Appellants asserted that they came under the spectrum of Bankers LIfe, as Appellants here also claim. The Court dismissed the Appellants' claim eloquently discussing the applicability of Bankers Life (at pps. 157-158 of 468 F.2d):

> "Plaintiffs also argue that Bankers Life and the foregoing cases expanding rule 10b-5 authorize their cause of action. We conclude, however, that permitting a cause of action to these plaintiffs would not be in keeping with the congressional purpose in enacting section 10(b); nor is it required by the interpretation in Bankers Life. When Congress enacted section 10(b), it did not contemplate the protection of every person injured by a fraudulent scheme in connection with the purchase or sale of securities. Its immediate concern was the protection of the party of the informational system in the securities market. The broad language in Bankers Life is reconcilable with this purpose. It is not so broad, however, as to expand the class of protected persons to include these plaintiffs. Although the immediate legislative focus was to safeguard the informational atmosphere in the securities market from deceptive devices and enervating impurities, it must be acknowledged that the broader focus of the

Securities Exchange Act was on protecting the investor and making the market place safe to trade. Equally disastrous to the investor would be schemes not involving misinformation but, nonetheless, directly related to the trading process, artifices leaving the investor with less than he bargained for. Thus, casting the seller who has parted with his securities but has been cheated of payment -- as occurred in Bankers Life -- to the vagaries of state law, the problems of state jurisdiction and service of process, would ill serve basic congressional policy. The Supreme Court in Bankers Life can be viewed as having exercised its inherent powers in developing a federal securities common law as a means of protecting the legislative scheme.

Rule 10b-5's expanded zone of interests under Bankers Life would not encompass the plaintiffs' interests in this case. They did not engage in any market transactions with the defendants by which they sustained their losses. Were we to extend the provisions of section 10(b) beyond the buyer or seller relationship, we would be judicially extending the terms of the statute and creating new rights. The consequences of the view urged by plaintiffs would establish a new and amorphous body of rights and obligations heretofore unrecognized in federal jurisdiction. Buyer or seller status is indispensable in establishing liability for damages under rule 10b-5. Exceptional circumstances may arise in which a stockholder might have a cause of action due to fraud in connection with the stock he holds and has not sold; that situation is not before us."

This Court's decision in Schlick v. Penn-Dixie Cement Corp., supra, 507 F.2d 374 (2d Cir. 1974) and A. T. Brod & Co. v. Perlow, supra, 375 F.2d 393 (2d Cir. 1967) are inapplicable to Appellants' complaint. In Schlick, there was no issue as to whether the alleged wrongdoing

and injury was connected with the purchase or sale of securities. A. T. Brod involved the failure of a defendant to pay for the purchase of securities ordered through a broker-dealer. Thus, there was also no issue of connection between the wrongdoing and the purchase of securities. Moreover, in A. T. Brod there was no issue as to whether the plaintiff was a purchaser in connection with the claimed fraudulent wrongdoing.

Appellants, in their brief (at p. 29), make the contention that the individual Appellants have standing to sue here merely because they were purchasers of securities. Appellants refer this Court to no authority for that position, and none exists. In order to have standing to sue under Rule 10b-5 claim, the purchase and sale of securities must be connected with the alleged wrongdoing and injury. Blau v. Lehman, 368 U.S. 403 (1962); Landy v. F.D.I.C., 486 F. 2d 139 (3d Cir. 1973), cert. den., 416 U.S. 1960 (1974); Simmons v. Wolfson, 428 F. 2d 455 (6th Cir. 1970), cert den. 400 U.S. 999 (1971); Birnbaum v. Newport Steel Corp., 193 F. 2d 461 (2d Cir. 1952), cert. den. 343 U.S. 956 (1952).

Appellants make the further contention (at pp. 30-33) that the corporate plaintiffs also have standing to sue in Count IV. With respect to Count IV, it is acknowledged that none of the corporate plaintiffs are alleged to have

made any purchase of securities. It is contended that because the corporate plaintiffs gave up consideration in connection with a purchase of Appellee Barnett's stock, the corporate plaintiffs have standing. No where in Appellants' point do they refer this Court to the complaint in support of their contention that the corporations gave valuable consideration or that there was a purchase. The simple fact is that there is no allegation in the complaint in Count IV that the corporations gave any consideration. Moreover, the cases referred to by Appellants in support of their proposition are irrelevant and have been superseded.

Pearlstein v. Scudder & German, 429 F. 2d 1136 (2d Cir. 1970), did not involve a claim under Rule 10b-5. Moreover, it involved the waiver of a claim which was unwittingly and involuntarily given by the plaintiff. Here, the corporate plaintiffs knowingly and voluntarily allegedly gave up some rights.

Eason v. General Motors Acceptance Corp., 490 F. 2d 654 (7th Cir. 1973), heavily relied upon by Appellants, is of no significance. The main holding in Eason was that there exists an exception to the Birnbaum doctrine of this Court permitting the maintaining of a Rule 10b-5 claim even though the plaintiff was not a purchaser or seller. The

Supreme Court decision of Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), specifically overruled Eason.

The remainder of Appellants' contentions (pp. 34-41) concerning the status of Appellees Julienne Barnett and Vi L. Messerli* are of no significance on this appeal. They do not provide the jurisdiction for the Court below, nor do they overcome the fatal deficiencies.

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* Appellee Vi L. Messerli was never served by the Appellants prior to the dismissal of the complaint and, accordingly, she never appeared nor was she a party to the action.

B. Any alleged misrepresentations in the Complaint were not material nor could any reliance be placed on them.

The complaint alleges that false statements and misrepresentations were made by Appellee Barnett. These alleged misrepresentations were not made in connection with the sale or purchase of securities by Appellants. Even if the misrepresentations are related to an alleged purchase, they do not constitute any basis for a Rule 10b-5 claim. The misrepresentations alleged in the complaint were not material nor would they have been relied upon. The complaint states that several statements purportedly made by Appellee Barnett to the individual Appellants were false. None of these statements, as a matter of law, are grounds for a claim under Rule 10b-5.

For any of the statements alleged in the complaint to be actionable under Rule 10b-5, such statements must be material. The Supreme Court has recently set down the applicable rule to be followed in determining the materiality of an alleged misrepresentation. The Supreme Court, in TSC Industries, Inc. v. Northway, Inc., U.S. 96 S. Ct. 2126 (1976), stated that the rule to be applied was the following (at p. 2131 of 96 S. Ct.):

> "The question of materiality, it is universally agreed, is an objective one, involving the significance of an omitted or

misrepresented fact to a reasonable investor. Variations in the formulation of a general test of materiality occur in the articulation of just how significant a fact must be or, put another way, how certain it must be that the fact would affect a reasonable investor's judgment."

The applicable section of the Act sought to be enforced in TSC Industries was not Section 10b of the Act, which is involved in this action, but Section 14a of the Act. However, the Supreme Court in TSC Industries observed in a footnote (at p. 2131 of 96 S. Ct.) that the test for determining materiality in 14a of the Act is similar to that previously determined by this Court for materiality under Section 10b of the Act. The Supreme Court specifically referred to this Court's decision in List v. Fashion Park, Inc., 340 F. 2d 457 (2d Cir. 1965). In the List case this Court set the standard to be followed in determining materiality as (at p. 462 of 340 F. 2d):

"The basic test of 'materiality' on the other hand, is whether 'a reasonable man would attach importance [to the fact misrepresented] in determining his choice of action in the transaction in question."

When these tests are applied to the statements attributed to Appellee Barnett in the complaint, it is clear that none of them are actionable under Rule 10b-5. The statements purportedly made by Appellee Barnett to the individual Appellants concerning the reason for the establish of LaBazoche were not material. The test to determine whether a statement is material is an objective

one involving the significance of the claimed misrepresentation. It is conceded by the complaint that the creation and effect of LaBazoche was disclosed by Appellee Barnett to the individual Appellants (A-11-12, Par. 15; A-14, Par. 17(b)). Appellants were made aware of the existence of the voting trust for LaBazoche and its effect in giving Appellee Barnett control over it.

Likewise, the statement purportedly made by Appellee Barnett in Count II of the complaint at the Board of Directors meeting concerning his estimate of the sales of Walborg and Coblentz was material. The statement was qualified by the explanation that he had no current financial statements due to IBM computer problems at the corporations.

This Court, in List v. Fashion Park, Inc., 340 F. 2d 457 (2d Cir. 1965), set forth the applicable test for determining whether there would be reliance upon an alleged misrepresentation. This Court said in List that (at p. 462 of 340 F. 2d):

> " . . . the test of 'reliance' is whether 'the misrepresentation is a substantial factor in determining the course of conduct which results in [the recipient's] loss.'"

Clearly, individual Appellants could not have placed any reliance on Barnett's estimate since they were aware that the estimates were made in a report to the directors without benefit of current financials.

Moreover, estimates similar in nature have been held not to constitute a basis for a claim under Rule 10b-5. SEC v. R. A. Holman & Co., 366 F. 2d 456 (2d Cir. 1966); Rochez Bros., Inc. v. Rhoades, 353 F. Supp. 795 (W.D. Pa. 1973); Black v. Riker-Maxson Corp., 1972 Transfer Binder, C.C.H. Fed. Sec. L. Rep. Par. 95,270 (S.D. N.Y. 1974); Ferland v. Orange Grove of Florida, Inc., 377 F. Supp. 690 (M.D. Fla. 1974); Schuller v. The Slick Corp., 1975-76 Transfer Binder, C.C.H. Fed. Sec. L. Rep., Par. 95,065 (S.D.N.Y. 1975).

In SEC v. R. A. Holman & Co., supra, 366 F. 2d 456, this Court observed that estimates of sales figures would not form the basis for a securities violation.

Reliance is also lacking with respect to the allegations in Count IV concerning the purported withholding of the corporate records by Appellee Barnett (A-29, Par. 43). It is acknowledged by the complaint that the Appellants were fully aware of the financial condition of the corporation when they "settled" and signed general releases (A-28-29, Par. 41 and 43), for it is claimed in the complaint that the corporations were in dire financial straits. Armed with this information, nothing contained in the corporate rec ords could have been material to the individual Appellants. Furthermore, individual Appellants could not have placed any reliance on the need for the corporate records

since the settlement was negotiated in a week of intensive night-long negotiations (A-28-29, Par. 42).

This Court recently had the occasion to rule on the kind of alleged representations asserted in Appellants' complaint in Titan Group, Inc. v. Faggan, 513 F. 2d 234 (2d Cir. 1975). In affirming a dismissal of the complaint, this Court said, at p. 238 of 513 F. 2d):

> "The parallel elements of materiality and reliance both serve to restrict the potentially limitless thrust of Rule 10b 5 to those situations in which there exists a causation in fact between the act and injury. Globus v. Law Research Service, Inc., 418 F. 2d 1276 (2 Cir. 1969), cert. denied, 397 U.S. 913, 90 S.Ct. 913, 25 L.Ed. 2d 93 F. 2d 457 (2 Cir.), cert. denied, sub nom. List v. Lerner, 382 U.S. 811, 86 S. Ct. 23, 15 L.Ed. 2d 60 (1965). Causation remains a necessary element in a private action for damages under Rule 10b 5. Shapiro v. Merrill, Lynch, Pierce, Fenner and Smith, Inc., 495 F. 2d 228 (2 Cir. 1974). . . . "

C. No damages to individual Appellants are alleged barring a claim under Rule 10b-5.

The complaint fails to set forth any actual loss or injury suffered by the individual Appellants. Any loss, if alleged at all in the complaint, related to the corporate waste and mismanagement claimed in the operation of the corporations. Count III of the complaint, the state claim, is the only one to allege speciffic loss or injury and that sustained only by Walborg. No allegation appears in Counts I, II or IV setting forth specific losses incurred by the individual Appellants. No damages are alleged to Rockley. In the absence of actual loss suffered by the individual Appellants, no claim can be asserted under Rule 10b-5 of Section 10b. The mere assertion of some speculative loss is insufficient. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); Estate Counselling Service v. Merrill, Lynch, Pierce, Fenner & Smith, 303 F. 2d 527 (10th Cir. 1962); Levine v. Seilon, Inc., 439 F. 2d 328 (2nd Cir. 1971); Wolf v. Frank, 477 F. 2d 467 (5th Cir. 1973); Rochelle v. Marine Midland Grace Trust Co., 535 F. 2d 523 (10th Cir. 1976).

The Supreme Court, in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, observed that in private damage actions brought under the Act, a plaintiff's recovery is

limited to "actual" losses incurred and not speculative ones. The Supreme Court utilized this rule of law reaching its holding that a claim under the Act must be limited to actual purchasers and sellers. The Court said, with respect to the need for actual loss (at p. 734 of 421 U.S):

> " . . . In contrast, a putative plaintiff, who neither purchases nor sells securities but sues instead for intangible economic injury such as loss of a contractual opportunity to buy or sell, is more likely to be seeking a largely conjectural and speculative recovery in which the number of shares involved will depend on the plaintiff's subjective hypothesis."

In this action the individual Appellants have prospered. They have succeeded in increasing their original holdings by forcing Appellee Barnett to give up his interest for a promise of payment he has not received, and for general releases which have not been honored by the Appellants (A-28-24, Par. 42). Moreover, Appellants' counsel asserted to the District Court that the corporation is making a profit. Obviously, the individual Appellees have suffered no loss through any of the transactions which they claim violate Rule 10b-5. Appellants' failure to allege any actual loss or injury is, in and of itself, a bar to maintaining this action under Rule 10b-5.

POINT II

No Diversity of Jurisdiction Exists.

Appellants' complaint also alleges jurisdiction for Counts I and II upon diversity of jurisdiction (A-VI, Par. I). No such diversity of jurisdiction exists, and although the District Court's opinion did not make a specific finding, it is presumed to have considered and found no diversity of jurisdiction since the complaint was dismissed.

The proper parties to assert the claims alleged in Counts I and II, as well as Count III, are the corporate Appellants. The basic allegations in all three Counts are the claim of corporate waste, mismanagement and misappropriation. The law is well settled that an action for waste, mismanagement and misappropriateion constitutes a wrong committed upon the corporation and not its stockholders. Dalva v. Bailey, 153 F. 2d 548 (S.D.N.Y. 1957).

With respect to Counts I and II of the complaint, the alleged wronged corporation Walborg is not named as a plaintiff. The reason Walborg or any of the other corporate Appellants are not named as plaintiffs is simply that they have their principal place of business in the same jurisdiction as Appellees reside in (A-7-9, Paras. 3, 4, 5, 6 and 7). The individual Appellants cannot assert

corporate claims as a stockholder derivative action. Under New York law (BCL, Sec. 626), such an action can only be maintained after demand has been made on the corporation and the corporation has refused to prosecute such a claim. No such allegation is made in the complaint and one is required to sustain a claim. Ross v. Bernhard, 396 U.S. 531 (1970).

The individual Appellants are conceded by the complaint to be in total control of the corporations at the time of the commencement of the action. Any demand by the individual Appellants would have to be accepted by the corporation; thus, Appellants have no colorable claim on any basis of diversity of jurisdiction under Counts I and II.

POINT III

The Complaint is deficient because it fails to plead Fraud with Sufficient Particularity.

Rule 9(b) of the Federal Rules of Civil Procedure requires allegations of fraud to be pleaded with particularity. Appellants' complaint does not plead the allegation of fraud with particularity, but, rather, only pleads the allegation purporting to allege corporate waste and mismanagement with particularity. Rule 9(b) is applicable

to a claim under Rule 10b-5 and Section 10b as well as the common law fraud claim. Segal v. Gordon, 467 F. 2d 602 (2d Cir. 1972); Shemtob v. Shearson, Hammill & Co., 448 F. 2d 442 (2d Cir. 1971).

Appellants' reference to Schlick v. Penn-Dixie Cement Corp., 507 F. 2d 374 (2d Cir. 1974), is misplaced. This Court, in the Schlick case, reaffirmed the applicability of Rule 9(b) to claims under Rule 10b-5. It is true that the Court, in Schlick, specifically found that that complaint pleaded fraud with particularity. However, Appellants' complaint failed to meet this requirement and must be dismissed for this reason as well.

POINT IV

Since there is no Federal Claim, Dependent Claims were properly Dismissed.

Once the District Court found that no Federal claim was stated by Appellants' complaint, it properly exercised its discretion in refusing to continue the action solely upon state claims under the principal of pendent jurisdiction. United Mine Workers of America v. Gibb, 383 U.S. 715 (1966); Iroquois Industries, Inc. v. Syracuse China Corp., 417 F. 2d 963 (2d Cir. 1969), cert. den., 399 U.S. 909 (1970).

The Supreme Court in United Mine Workers of America v. Gibbs, supra, 383 U.S. 715, depositively said, with respect

to pendent claims (at p. 726 of 383 U.S.):

> "Certainly, if the Federal claims are dismissed before trial, even though not insubstantial in a jurisdictional sense, the state claims should be dismissed as well."

CONCLUSION

The District Court properly dismissed Appellants complaints. The Order appealed from should, in all respects, be affirmed in this Court.

Respectfully submitted,

VINCENTI & SCHICKLER
Attorneys for Appellees
Norman N. Barnett and
Julienne Barnett

Of Counsel:

J' HAN S. GAYNIN, Esq.

376—Affidavit of Service by Mail

United States Court of Appeals
for the Second Circuit

The Reporter Co., Inc., 11 Park Place, New York, N. Y. 10007

Maxime C. Baretge; Rockley Associates, S.A. ; Poerre Macheras
David W. Trimble ; The Rockley Group Inc., Bazoche Inc.,
Walborg Corporation ; and Coblentz Bag Co. Inc.,
Plaintiffs-Appellants

against

Norman W. Barnett, Julienne Barnett, Vi L. Messerli
Defendants-Appellees

State of New York, County of New York, ss.:

Raymond J. Braddick, agent for Vincenti & Schickler, being duly sworn deposes and says that he is the attorney for the above named Defendants-Appellees herein. That he is over 21 years of age, is not a party to the action and resides at Levittown, New York

That on the 1st day of December, 19 76, he served the within

Brief

upon the attorneys for the parties and at the addresses as specified below

Carro Spanbock Rodman London & Fass Esqs.
1345 Avenie of the Americas
New York, New York

by depositing 3 true copies
to each of the same securely enclosed in a post-paid wrapper in the Post Office regularly maintained by the United States Government at
90 Church Street, New York, New York
directed to the said attorneys for the parties as listed above at the addresses aforementioned, that being the addresses within the state designated by them for that purpose, or the places where they then kept offices between which places there then was and now is a regular communication by mail.

Sworn to before me, this 1st.
day of December, 19 76

Raymond J. Braddick

Notary Public, State of New York
No. 4509705
Qualified in Delaware County
Commission Expires March 30, 1977